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The outlook for the global economy and Italy

Address by the Governor of the Bank of Italy

Antonio Fazio

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1. The international economy

The world economy grew by 5 per cent in 2004, the largest increase in more than twenty years; domestic demand in the United States and a number of emerging Asian economies contributed to the expansion. World trade increased by 9 per cent. Growth remained weak in the euro area and came to a halt during the year in Japan. The rise in oil prices slowed economic activity marginally.

The US economy grew at an average annual rate of 3.1 per cent in the period 2002-04. The increase in public spending, the tax relief measures and the large reduction in interest rates sustained household consumption and encouraged a revival of investment.

Output grew in 2004 by 4.4 per cent. The improvement in labour productivity, up by 4.1 per cent on average for the year, curbed inflation and buoyed corporate profits.

Payroll employment rose by 2,200,000 during the year, making good all the decline that had occurred between the beginning of 2001 and the middle of 2003. The growth in employment sustained consumption and compensated for the drying up of the effects of the tax cuts on disposable income; the liquidity provided by mortgage refinancing also decreased.

The business sector’s expectations regarding the growth of the economy are revealed by the performance of investment.

At the beginning of 2003 investment in high-tech capital goods had already reversed the downward trend of the previous two years, rising at an annualized rate of

17 per cent. In 2004, with profit margins widening and financial conditions favourable, purchases of machinery also picked up rapidly. Spending on machinery and software increased by 13 per cent, compared with 6 per cent in 2003.

Household expenditure rose by 4.1 per cent on an annual basis in the second half of the year; the saving rate declined further.

The increase in the consumer price deflator, excluding energy and food products, rose from 1.1 per cent at the end of 2003 to 1.5 per cent at the end of 2004.

At each of the six meetings of the Federal Open Market Committee held between 30 June 2004 and 2 February of this year, the federal funds target rate was raised by 25 basis points, bringing it to 2.5 per cent. As the Federal Reserve has emphasized in its press releases, monetary conditions continue to be accommodative. The markets expect further increases in interest rates in the coming months, for a total of 50 basis points.

The federal budget deficit rose to 3.5 per cent of GDP in 2003. In the fiscal year that ended last September the ratio was virtually unchanged. If no new measures are adopted, and including the additional funds being finalized to cover defence spending, the deficit is expected to decline to 3.3 per cent of GDP in 2005.

The US President has announced that the objective of budget policy will be to halve the ratio of the deficit to GDP by 2009, mainly by curbing expenditure. He stated that the priorities for his new term of office included reforming the public pay-as-you-go pension system, which currently provides benefits to around 45 million people for an annual outlay of $500 billion, or less than 5 per cent of GDP. The aim of the proposed reform is to prevent the emergence of growing financial deficits from 2018 on; it hinges on the introduction of individual accounts which would progressively be credited with part of the contributions presently paid into the public system.

Looking ahead, the imbalance in the US external accounts will be a drag on the American economy, and consequently on the world economy.

The current account deficit continued to increase in 2004. The improvement in price competitiveness brought by the weakening of the dollar has had very little effect. In 2004 the deficit amounted to 5.5 per cent of GDP; in 2005 it will exceed 6 per cent.

The net international investment position of the United States, which was practically in balance at the beginning of the 1990s, subsequently deteriorated, with net foreign debt rising to a quarter of GDP in 2004. The worsening of the external imbalance is basically linked to the growth gaps between the US economy on the one hand and the European and Japanese economies on the other.

The Federal Reserve has announced that there have been no major difficulties in financing the current account deficit, but it has also stressed that the growth in net foreign liabilities cannot continue indefinitely at the present rate. In order to maintain a rapid pace of capital formation, the Federal Reserve has called for a reduction in the budget deficit and measures to increase household saving.

In Japan, economic activity slackened in the course of 2004, after expanding by around 7 per cent on an annual basis in the first quarter. Exports, which had been growing rapidly since 2003, were flat in the second half of the year; private investment slumped. It is estimated that output picked up slightly in the fourth quarter. Growth over the year is expected to have been close to 3 per cent.

In the euro area, the recovery is struggling to gather momentum. It is hampered by the rapid ageing of the population. Structural factors hinder an improvement in productivity. The scope for macroeconomic policies remains limited: in the case of monetary policy this is due to the low flexibility of the economy; in that of budget policy to the size of the deficits.

Buoyed by international trade, euro-area output grew at an annualized rate of 2.2 per cent in the first half of 2004. The upturn in exports was accompanied by a gradual increase in purchases abroad, partly in response to the lagged effects of the euro's appreciation. Following a renewed slackening of consumer and investment demand, output slowed in the third quarter; over the year as a whole it is estimated to have risen by 2 per cent.

We have kept the rate on main refinancing operations in the euro area unchanged at 2 per cent in view of the expectations of a fall in inflation to below 2 per cent and the still uncertain recovery.

Short-term interest rates have been close to zero in real terms since the start of 2004. The market expects them to remain below 1 per cent until the middle of this year.

An important contribution to the growth of the world economy has come from the emerging economies of Asia. In 2004 the increase in GDP was around 7.5 per cent. In China it was 9.5 per cent; investment rose by 26 per cent in nominal terms; signs of overheating have emerged on the price front. Despite the substantial increase in imports, the trade surplus widened from \$26 billion in 2003 to \$32 billion last year. The authorities are still endeavouring to bring the rate of expansion in economic activity back to a sustainable path.

In India economic activity continues to expand at a rapid pace; in 2004 GDP grew by 6.4 per cent.

Latin America experienced growth of 5 per cent in 2004, compared with 1.8 per cent in 2003. The acceleration involved all the main countries; in Brazil, GDP grew by approximately 5 per cent.

In Argentina, the recovery, which got under way two years ago, was driven by the strong expansion of domestic demand and the good performance of exports; in the last three years there has been a large trade surplus. In the first three quarters of 2004 the growth in GDP amounted to 8.8 per cent year on year. The peso's exchange rate against the dollar, which at mid-2002 had weakened to nearly 4 to 1, subsequently staged a recovery and has stabilized at around 2.9 pesos to the dollar since 2003. Benefiting above all from the increase in revenue produced by the strengthening of economic activity, the primary surplus on the federal budget rose to 3.6 per cent of domestic output in the first nine months of 2004, from 2.8 per cent in the corresponding period of 2003. The problem of restructuring the debt remains open at international level.

2. The financial markets

As we have pointed out for some time now, conditions of abundant liquidity prevail in the international markets. The credit and monetary expansion has been very robust in recent years in the United States and Japan and has spread to the emerging economies of Asia whose currencies have been managed with reference to the dollar. Since the beginning of 2002 the broad measure of the money supply has grown by 56 per cent in China, by about 20 per cent in South Korea, and by between 12 and 16 per cent in the other Asian countries.

In Europe, the 12-month growth rate of the M3 money supply, after falling to 4.9 per cent in May 2004, rose to around 6 per cent in December as a consequence of the expansion in currency in circulation.

The plentiful supply of credit at global level has had a limited impact on consumer price inflation, thanks to greater competition and the spread of products originating from countries where labour costs are extremely low and social protection is scanty. In the United States, large productivity gains have helped to contain inflation.

Bond and share prices in the industrial and the emerging countries remained stable at the high levels of the start of 2004. By contrast, in most of the industrial countries house prices continued to rise.

Yields on ten-year government bonds have stabilized since October at around 4 per cent in the United States and approximately 1.4 per cent in Japan. In the euro area, given the low inflation rate and the uncertainty about the strength of the recovery, long-term yields fell to 3.6 per cent in January of this year.

The yield spread between the bonds of US companies with a high credit rating and ten-year Treasury paper was equal to 0.9 percentage points in January; the corresponding spread for the securities of riskier companies has stood at 2.8 points since last October. A factor helping to curb the cost of financing has been the strengthening of the profitability and balance sheets of the corporate sector as a whole, which is also reflected in the persistent reduction in defaults and the improvement in the balance between corporate rating upgrades and downgrades.

In the euro area, the growth in lending to the private sector was 7 per cent in December compared with the end of the previous year; the increase was nil in Germany, 7 per cent in Italy.

In Europe too, the spreads between non-financial-sector euro-denominated bonds and government securities are currently at very low levels. According to Moody's, at the end of 2004 defaults in the international market were equal to 0.2 per cent of the total amount of issues outstanding, the lowest rate since 1997. There was a further improvement in the rating agencies' assessments of the creditworthiness of issuers.

Thanks to the good performance of profits, in the United States and the euro area the ratio of share prices to earnings, declining since March 2002, has fallen further and is basically back in line with the long-term levels.

House prices have accelerated in many industrial countries since the end of the 1990s: between 1999 and 2003 they rose in the United States, France and Italy at average annual rates around 6 percentage points higher than the rise in consumer prices; in the United Kingdom and Spain, the increase in real terms was around 12 per cent.

In 2004 property prices again rose sharply with respect to the previous year; in the third quarter their increase outpaced that in consumer prices by 19 percentage points in the United Kingdom, 10 points in the United States, and 13 points in France and Spain. In Italy house prices rose by 9 per cent in nominal terms in 2004, compared with 11 per cent the previous year; in Germany and Japan, continuing a trend under way since the early 1990s, they fell slightly again in 2004.

In the main emerging countries, after the increase in risk premiums recorded last spring, there was a return to relaxed financial conditions; in mid-January 2005 the spreads stood at very low levels, reflecting the strengthening of economic activity, the good performance of exports and abundant liquidity.

In general, current conditions in the international financial markets are characterized by low interest rates and risk premiums. The large expansion of derivative products in the course of the last two years has redistributed risk towards market participants better able to absorb it. The markets are not signaling risks of instability at global level.

3. Exchange rates and external imbalances

According to the indicator calculated by the Federal Reserve, between February 2002 and January 2005 the effective exchange rate of the dollar fell by 15 per cent in both nominal and real terms. Over the same period the euro appreciated by 24 per cent in nominal terms and by 21 per cent in real terms. The yen strengthened by 7 per cent; in real terms it depreciated by 3 per cent.

In 2004 the central banks of the Asian countries again intervened on the foreign exchange market with massive purchases of dollars. In Japan the official reserves rose to $850 billion, in China they grew by about $200 billion to exceed $600 billion; in the other Asian countries they now amount to $830 billion.

Reserve assets, mostly denominated in dollars, are equal to about 18 per cent of GDP in Japan and to about 37 per cent in China.

Generally low rates of inflation and the peg to the dollar have enabled some Asian countries to improve their competitiveness: since February 2002 the real effective exchange rates of the currencies of China, Hong Kong and Malaysia have fallen by between 9 and 17 per cent. The competitiveness of Thailand and Taiwan has remained unchanged, while that of South Korea and Singapore has deteriorated slightly.

After the financial crisis of 1997 the reference to the dollar in the management of exchange rates resulted in only limited changes in competitiveness among the emerging and newly industrialized Asian countries, thereby encouraging the growth of regional trade, which has increased to about half the total. This integration reflects the spontaneous development of vertical integration of production within the region, in which each country tends to specialize in one phase of production.

In the last ten years China's share of international trade has increased significantly. It takes 13 per cent of Japan's exports and 17 per cent of those of the other emerging Asian countries: it imports capital goods and components from Japan, South Korea and Taiwan. It exports manufactures, for some ten years now mainly to the markets of the industrial countries.

As globalization proceeds, the emerging Asian economies, which have very low labour costs and faster productivity growth than the United States, cannot pursue policies aimed at stabilizing the exchange rate against the dollar for ever. Such policies risk boosting inflation and fueling excessive increases in the prices of financial and real assets.

In 2004 the large external deficit of the United States had a counterpart in the substantial surpluses of the Asian countries, which totaled about $330 billion. The surplus of the euro area rose from $26 billion in 2003 to about $50 billion, or 0.5 per cent of GDP.

At present the bulk of Asia's current account surplus is generated by Japan, which in 2004 contributed $170 billion; another major contribution, of $90 billion, was made by the newly industrialized economies. According to the IMF, in 2004 the current account surpluses of China and the other Asian developing countries amounted to $38 billion and $30 billion, respectively. In the last few years India has recorded modest surpluses.

Even though all the Asian countries have been running large current account surpluses, their net international investment positions differ. Japan has had a structural current account surplus from the postwar period onwards. China began to record current account surpluses in the early 1990s. In South Korea and other important emerging Asian countries surpluses are of more recent date.

In the ten years prior to the crisis of 1997, the persistent deficits of the emerging Asian economies had resulted in their accumulating a high level of foreign debt. The crisis forced these countries to make an abrupt adjustment; a substantial current account surplus followed. Despite the subsequent rapid recovery of economic activity in the region, the surplus continued to grow, rising in the last three years from 2.4 to 3.7

per cent of GDP as a consequence of the upturn in world trade and the favourable competitive position.

The differing net investment positions affect countries' propensity to keep on accumulating dollars and, more generally, foreign exchange reserves.

4. Italy

In the first nine months of 2004 GDP growth in Italy was 1.2 per cent on an annual basis, 0.7 percentage points less than in the rest of the euro area. The growth gap, which had been nearly closed in the course of the previous three years, thus widened again in concomitance with the less favourable performance of exports.

In the first three quarters Italian exports grew by 3.3 per cent compared with the same period of 2003, approximately half the increase recorded by the other euro-area countries as a group. The balance-of-trade data indicate they slowed down in the final months of the year. Given the buoyant expansion of world trade, Italy's share of world exports of goods is estimated to have fallen to around 2.9 per cent in volume terms.

The loss of world trade shares that began in 1996, when Italy returned to the European exchange rate mechanism, has continued. The substantial stability of the currency has not been accompanied by structural reforms capable of increasing competitiveness as much as in the other industrial economies. Italian exports continue to be held back by the loss of price competitiveness, due largely to the poor performance of productivity.

The deterioration in manufacturing efficiency by comparison with the leading industrial countries, under way since the mid-1990s, has been aggravated in recent years. Between 2000 and 2003, total factor productivity in industry fell by about 1 per cent a year. The competitiveness of Italian goods, as measured by unit labour costs, declined by nearly 15 per cent between the start of 2002 and the end of 2003, or 9 points more than the deterioration in Germany and France.

In the first nine months of 2004, with nominal exchange rates essentially stable, Italian competitiveness continued to suffer from a faster rise in unit labour costs. Earnings per employee rose by 2.8 per cent in the entire economy and by 2.3 per cent in the non-farm private sector. But there was no adequate gain in productivity. The rise in unit labour costs in Italy thus exceeded that in France and Germany by 1.4 and 3.5 percentage points respectively.

Italian household consumption rose by 1.2 per cent in the first quarter of 2004 with respect to the previous three months, but then remained almost flat for the next two quarters.

Harmonized consumer price inflation was 2.3 per cent in Italy in 2004, as against 2.1 per cent in the euro area. According to the January *Consensus Forecasts*, inflation is expected to fall to 2.1 per cent this year in Italy and to 1.8 per cent in the area as a whole.

Investment in machinery, equipment and transport equipment, which in the first half of 2004 recouped the contraction registered in 2003, turned downwards again in the third quarter, reflecting uncertainty over the recovery in economic activity. Investment in residential construction continued to expand. Public works activity slowed sharply in the second half of the year after a lively expansion in the first.

The uncertain path of investment and the decline in industrial production have braked the expansion of employment. The more intensive utilization of labour in connection with wage moderation and with the greater flexibility produced by the reforms enacted since the early 1990s appears to have come to an end. In the third quarter the number of persons employed was 0.2 per cent higher than in the fourth quarter of 2003. In industry, following the moderate expansion recorded between 2000 and 2002, employment began to contract again in line with production.

The unemployment rate fell in 2004, mainly owing to the decline in labour force participation.

The diminution in the supply of labour interrupted the decade-long process of convergence towards the average European participation rate. There was a decline in labour force participation by young people in the South, especially women.

More systematic action, including training programmes, is needed to raise labour market participation rates.

Bank lending was 6.7 per cent greater in December than a year earlier. There was a slowdown in the North and Centre, while the growth in lending accelerated further in the South to 10.5 per cent. Credit to consumer households, essentially for the purchase of houses, increased by 16 per cent.

The value of new bad loans remained limited. Qualitative and quantitative indicators show that credit supply conditions continue to be easy. Interest rates are still extremely low. Secondary market yields on Italian corporate Eurobonds are in line with those on the bonds of other international issuers.

5. The banking system and the corporate sector

Since the early 1990s the Italian banking system has undergone a transformation on an historic scale. Initially, 68 per cent of total assets were held by banks controlled by the state or by foundations; today the figure is close to 10 per cent.

Most of the banking groups are controlled by a core group of investors comprising intermediaries, foundations and, in some cases, firms with minority interests. Important international financial intermediaries are present in a higher proportion than in other European banking systems.

Foreign banks and financial institutions currently hold an average of 17 per cent of the capital of the four largest banking groups; for the 10 largest groups, the share held by foreign intermediaries is 11 per cent.

On the basis of BANKSCOPE data, foreign intermediaries hold 7 per cent of the capital of the four leading banking groups in Germany, 3 per cent in France and 2.6 per cent in Spain.

In the privatization process, foundations' and public entities' sales of shareholdings were facilitated in the second half of the 1990s by buoyant share prices. In disposing of their holdings in banks, the foundations and public entities fostered the creation of stable core groups of controlling shareholders.

Mergers and acquisitions have resulted in the number of banks operating in Italy falling from 970 in the mid-1990s to 785; 443 are mutual banks. Initially the market share of the four largest banking groups was 30 per cent; by June 2004 it had risen to 44 per cent.

Some 80 per cent of total assets are held by groups headed by banks listed on the stock exchange.

In the mid-1990s the return on equity of the Italian banking system was less than 2 per cent. Today, after rising to approximately 13 per cent in 2000, it is close to 11 per cent.

All the indicators point to a considerable increase in banking competition; this is confirmed by the evolution of the structure of the market and interest rates, and by the redistribution of intermediaries' market shares.

In the regional loan markets there has been a marked decrease in the index of concentration. Compared with the mid-1990s, the average cost of short-term bank credit has fallen by more than 8 percentage points and is now in line with the euro-area average; the spread between short-term lending and deposit rates has narrowed from 6 to 4 percentage points.

The Italian banking system is now in a position to compete in Europe. It is expanding its presence in Central and Eastern Europe.

Italian banking groups are smaller than the major euro-area intermediaries; the indicators of operating profitability and efficiency are nonetheless better than the average for the banking systems of the area.

The integration of the groups formed during the last ten years is at an advanced stage as regards corporate structure, operating procedures and information systems. Further combinations between large groups within the Italian banking system would entail serious problems in terms of the creation of dominant positions and a substantial reduction in competition in a number of regions and provinces.

Account must also be taken of the uncertainty surrounding the productivity gains obtainable from the increase in size, owing to the organizational complexity of the entities that would be created.

Combinations of regional and medium-sized banks are producing efficiency gains.

There has been a revival of discussion on the possibility of additional mergers in Europe, where the size of banks is deemed inadequate compared with that of the major banks of the other main monetary areas.

On the basis of the experience of recent years, the benefits of additional mergers are uncertain for large groups. At world level some of the largest banking groups have encountered serious difficulties. In other cases obstacles have emerged to the efficient control of operations in different lines of business and countries.

In wholesale banking there is already a fully-fledged single market at international level. For financial services, the key factors are intermediaries' technical skills and reputation and their links with countries with developed capital markets.

In the Italian market, from the beginning of 2000 up to June of last year, foreign banks managed, through their branches, 30 per cent of the issues of securities by Italian and foreign non-financial companies and a quarter of the issues of international financial institutions. Foreign banks placed more than 70 per cent of the value of the roughly 200 issues of Eurobonds made by Italian firms. The leading international banks dominate M&A activity in the Italian market.

As for retail banking, a dominant role in all the European countries is played by domestic intermediaries. These have detailed knowledge of the legal and institutional context and of the characteristics, needs and creditworthiness of customers, especially those of smaller size.

A recent report prepared under the auspices of the G-10 Finance Ministers and Central Bank Governors shows that bank mergers and acquisitions mainly involve domestic intermediaries in all the leading economies. In Europe most of the few cross-border mergers that occurred were between intermediaries based in countries with institutional, cultural and linguistic affinities or involved a bank in financial distress. When intermediaries of different countries are combined, legal and institutional differences and cultural barriers may hamper the transfer of managerial skills from the acquiring bank to the bank acquired.

In Italy the fruitfulness of collaboration with intermediaries of other countries is attested to by the extensive participation of foreign capital in the Italian banking system, by numerous cooperation agreements for the distribution of financial and credit products and by the significant role played by foreign intermediaries in wholesale banking.

The Bank of Italy examines every proposal submitted to it for mergers or acquisitions of major equity interests to be carried out by Italian banks vis-à-vis Italian banks, by Italian banks vis-à-vis foreign banks and by foreign banks vis-à-vis Italian banks. It applies Italian and Community law; it performs its statutory mandate of ensuring the sound and prudent management of credit, protecting the stability of intermediaries and of the system as a whole, and promoting competition.

In the last few years Italian banks have provided financial support to firms, including large ones and some involved in extensive restructuring. They have directed very large volumes of credit to small and medium-sized enterprises, which are an important part of the Italian economy. In the financing of such businesses, there has been a steady increase in the proportion of credit provided by banks rooted in the local economy.

For Italian banks, reducing costs and improving internal organization remain key objectives. Product innovation and the reduction of unit costs must be to the benefit of firms and households. They must be turned into an improvement in the quality of the products supplied and be reflected in the prices of retail services, above all for payment services and asset management.

In a period of low inflation it is only right for banks to limit the fees charged on retail services.

Progress in this direction, correct and professional conduct strengthen the relationship of trust with customers and are conducive to the orderly growth of intermediation business.

In collaboration with the Antitrust Authority, we have launched a fact-finding inquiry with the aim of ascertaining the existence, for some services, of strategies and costs that discourage customers from changing bank.

Over the last ten years, the banking system has been marked by a process of consolidation and a progressive increase in the average size of individual intermediaries, whereas the industrial and service sectors have experienced further fragmentation, with inevitable adverse effects on the productivity and competitiveness of the whole economy.

The number of large industrial groups, essential for the spread of new technologies, is limited. The system of industrial districts, which in past decades helped to generate the synergies and efficiencies typical of large groups within clusters of small firms, now seems less able on its own to sustain a further drive to improve competitiveness.

The shortage of infrastructure and the cost of energy and services for firms are a drag at national level.

Spending on research by both the public sector and the private sector is particularly low in Italy by comparison with the other advanced economies. The proportion of value added by high-technology sectors is very small.

This affects Italian products' penetration of international markets. Italy's share of world exports of goods and services in volume terms was approximately 4.5 per cent in the mid-1990s; in 2004 it fell below 3 per cent.

Industrial production follows the performance of exports. For several years now, as we have documented on other occasions, its growth in Italy has fallen appreciably short of that recorded both in the euro area as a whole and in the area's two largest countries, Germany and France. In 2004 Italy's index of industrial production showed a slight tendency to decline.

To a degree, the transfer of traditional production to countries with low labour costs and rapidly expanding demand is normal. In Italy the phenomenon has intensified since the mid-1990s; the number of workers employed in foreign companies invested in or controlled by Italian firms has reached one fifth of the total number employed in domestic industry. In recent years, the prevalent reason for investment abroad appears to have been to cut costs; direct investment aimed at increasing firms' presence in advanced markets has contracted sharply. The strategies that will enable the system to reap the maximum benefit from internationalization need to be identified; better knowledge and thorough analysis of the phenomenon are necessary.

An economic policy that intends to revitalize Italian industry must necessarily come to grips with the problem of firm size, in part by encouraging mergers and acquisitions.

There are difficulties, above all in connection with the ownership structure of Italian firms.

The banking system, which possesses databases and extensive and detailed information on the structure and profitability of firms, can promote mergers and acquisitions, provide the financial assistance and services needed to make the productive system more solid.

The Italian economy contains instances of excellence in innovative and creative ability, not just in the traditional branches of activity but also in high technology. These more dynamic units can act as poles of aggregation for less productive firms.

It's a challenge in which we cannot fail, in order to improve an important part of our economy.

6. The outlook

The overall expansion of the world economy is set to continue this year.

In the United States, GDP is expected to grow by about 3.5 per cent.

Short-term interest rates were drastically reduced in the weak phase of economic activity. They are currently nil in real terms; increases are expected in the course of the year.

The supply of dollar-denominated securities has been abundant in the past few years, reflecting the high public sector borrowing requirement and robust investment.

From the low it touched in the closing days of last year, as of yesterday the dollar had recouped 6 per cent against the euro.

Although, as mentioned earlier, the level and structure of yields do not signal risks, a growing imbalance between the demand for and the supply of savings in the largest industrial economy looms over the global financial system.

A current account deficit in 2004 of $600 billion, a little more than 1.5 per cent of world GDP at current exchange rates, was absorbed with a depreciation of the dollar but without serious strains in the markets, in a year in which the world economy grew by 8 per cent in nominal terms and the demand for financial assets expanded even faster.

The quantity of dollars as defined by M2 increased by 38 per cent between 1999 and 2004; over the same period the stock of public and private-sector bonds grew by 45 per cent. The sum of the two aggregates rose to 260 per cent of America’s GDP.

For the euro, the money supply and the stock of bonds increased by 48 per cent over the same five years, and the volume of assets denominated in euros rose to 235 per cent of the area’s GDP. In Japan, the money supply and securities grew by 35 per cent; their ratio to GDP is far higher than in the other two main monetary areas.

The expansion of the world money supply and, to an extent, that of private and public-sector bonds in relation to GDP have had bullish effects on share and especially property valuations. Consumer price inflation has been held in check by the increase in productivity and competition.

The external current account deficit of the United States for the current year is expected to be of the order of $700 billion.

The ability of the international markets to finance large imbalances between saving and investment in the major industrial countries has increased markedly in the last few years. The world economy will continue to absorb dollar-denominated financial assets; excessive repercussions on exchange rates and yield spreads can be avoided if the expansion of the quantity of dollars is not substantially greater than that of the other main currencies.

Important factors, in this context, will be the overall balance sheet position of the private and public sectors in the three monetary areas, the growth expectations for the US economy, and the willingness of global financial intermediaries to increase the share of their dollar holdings further, while reducing that of other currencies and their domestic currency.

A large loss of value by the dollar would be harmful for the orderly functioning of the financial system and the world economy.

The increase in official interest rates should help to sustain the external value of the dollar during 2005.

The resolve of the US administration, which it recently reaffirmed, to reduce the budget deficit substantially is crucial. But in a long-term perspective, a more balanced relationship between the major currencies cannot come about without a return to faster growth in Europe and Japan.

In Japan, according to the estimates of the central bank, the increase in GDP will be approximately 2 per cent this year. In the emerging areas the pace of growth is likely to slow somewhat but will nevertheless remain very rapid. According to the IMF, growth will diminish to 3.6 per cent in Latin America, 7.5 per cent in China and 5.5 per cent in the other emerging Asian economies; at world level, the expansion in GDP is forecast at 4.3 per cent.

In the euro area, the cyclical indicators weakened during the autumn. In November manufacturing output registered its second consecutive decline, reflecting the contraction in activity in Germany and Italy and stagnation in France.

Indicators of the climate of confidence have not yet signaled a clear reversal of trend in the expectations of households and firms in the main countries, except in Germany, where the last few months have seen an improvement. The international organizations forecast area-wide growth to be approximately 2 per cent this year, about the same as in 2004.

In Italy, GDP growth in 2004 is estimated to have been approximately 1.5 per cent.

According to preliminary estimates, industrial production declined by 0.5 per cent in the fourth quarter, and appears to have contracted slightly again in January.

During 2005 the expansion in output is expected to gain pace, as a consequence of an acceleration in exports and in the domestic components of demand.

A policy aimed at raising the Italian economy's growth potential appears increasingly necessary.

Prerequisites for this are the structural adjustment of the public finances and the lowering of the ratio of debt to GDP. The Government is considering a set of measures to improve the economy's competitiveness. Their prompt implementation is essential to bolster the still uncertain propensity of firms to invest.

Factors of fundamental importance are the development of basic and applied research, in part through closer relationships between universities and firms, the transfer of matters from primary to secondary legislation, and the reduction in the number of authorization procedures. The prompt implementation of the public works plan requires mechanisms, including extraordinary instruments, to speed up procedures and execution. The reform of bankruptcy law, which can no longer be put off and should be implemented in the form of a decree-law or enabling law, will benefit the protection of businesses, workers, creditors and banks.

The Italian banking system can sustain a higher rate of economic and investment growth. It will also benefit from a stronger economy. Its stability and efficiency are the guarantee for the savings entrusted to it and for their fruitful investment to the advantage of economic activity.

With a united effort, we must establish the conditions for faster growth. Among the measures for competitiveness, special attention must be paid to the South, with its resources of labour, intelligence and initiative.

Growth realizes the potential of labour flexibility through the employment it brings.

Economic policy action, the response of the social partners and the institutions can create the climate of confidence that is necessary for enterprise and innovation. We must increase our commitment on behalf of those, especially young people, who are convinced that a better future can and must be built.